

Cost Recovery and Tariff Policy in MCC Compacts

Background

MCC projects must inter alia satisfy two investment criteria: (1) achieve an economic rate of return equal to or above ten percent (the ‘hurdle rate’) and (2) operate sustainably after the MCC compact’s completion. In applying these criteria to a candidate project, MCC conducts a rigorous cost-benefit analysis built around a project logic and estimates benefits over a standard 20-year project life cycle. Increasingly, MCC has emphasized the role of policy reforms to support sustainable development outcomes and ensure the productive life of project assets. Such policies have targeted, for example, public utilities, introducing independent regulatory bodies and tariffs that recover maintenance costs. By conditioning disbursements on such policies, MCC incentivizes a more sustainable approach to infrastructure maintenance and service delivery. Recent investments in water distribution and treatment (Mongolia, Jordan and Zambia) and the power sector (Malawi, Ghana and Senegal) have deepened MCC’s experience.

MCC’s current practice and challenges

As part of its investments in new utility infrastructure, MCC typically calls for adjusting user tariffs to cover recurrent O&M costs. If long term financial sustainability of the utility is the objective, then MCC has also supported full cost recovery to cover both O&M and capital costs. If a service user does not pay the cost of ongoing provision of that service (including maintenance, pumping costs, etc.), then implicit or explicit subsidies are required to keep the service operational. Otherwise service standards are expected to decline.

Achieving O&M cost recovery remains elusive, despite MCC country team efforts, institutional reform efforts, and disbursement conditionalities.¹ MCC-developed road funds have strayed from their initial purposes (e.g. Moldova and Liberia), energy tariffs have been reversed following compact completion (e.g. Mongolia), and water tariffs rarely reach cost-recovery levels and often receive heavy government subsidies, outcomes which incentivize wasteful consumption. However, raising tariff rates is difficult politically. Studies by MCC’s Department of Compact Operations acknowledge that extremely low tariff rates paid by consumers in Compact countries, particularly for water, render any O&M cost recovery efforts unlikely to succeed. Consequently, MCC’s cost-benefit analyses increasingly avoid assumptions about achieving full O&M cost recovery. Instead, the analysis may assume an accelerated depreciation of the physical asset (e.g. HDM4 model adjustments for roads projects), effectively reducing the expected

benefit stream of the project.

When judging and designing new projects for implementation, the focus on cost recovery also competes with the priority of equitable access to vital services. Low-income households or remote populations often cannot bear the full cost of services or connection fees. The possibility that fees received from certain users could in turn subsidize others may present an opportunity to distribute benefits in ways that achieve larger social objectives. Similarly, disaggregating the beneficiaries of these services, e.g. by income quartiles, may inform the strategy of O&M cost recovery as well as the balance struck between user tariffs and subsidies.

Balancing economic efficiency against social fairness remains a challenge with which MCC compacts grapple.²

MCC Past experience on tariff reform and Country Cases

MCC has not consistently sought full cost recovery (O&M and capital costs) or only O&M recovery. Furthermore, impacts of investments often fall short of stated goals or fade soon after compact completion. To date, about half of MCC's portfolio includes cost recovery components, spread across 16 transport projects, 14 energy projects, 5 WASH projects, and 3 irrigation projects. Below are some examples from MCC compact experience.

Ghana II	The Ghana II compact includes a power sector reform aspect that aims to restructure tariffs to be more cost reflective which is included as Conditions Precedent for investment. The Compact is not specific concerning what types of costs are expected to be covered and to what extent. Full cost recovery is implicit in the risks section of the Investment Memo which questions whether the government will move toward a fully cost reflective tariff. While tariff reform is a Conditions Precedent in the compact, the ability for the compact to achieve full cost recovery is uncertain.
Jordan	In the Jordan compact for water services and waste water treatment , a full O&M cost recovery plan was made an explicit part of the condition precedent in the compact. The Compact Closeout report notes that with regards to the infrastructure activity the utility expects full cost recovery by 2019, but this was not achieved during the life of the compact and uncertainty remains.
Benin II	The Benin II compact made electricity tariff adjustment to cover O&M a condition precedent of the investment. The condition attempts to get the Government of Benin to improve their cost recovery ratio. An increase in tariff is planned by the government but MCC doesn't expect the tariff to achieve O&M cost recovery. Whether the impact of the reforms will be sustained post compact is uncertain.

Moldova	<p>The Moldova Compact made tariffs and public subsidies to meet O&M needs for irrigation and roads a conditions precedent of the compact. For roads the CP and MCC encouragement established a national road maintenance fund through fuel levies in the 3rd year of the compact. However, during the post compact period, a significant portion of the fund was siphoned out for other purposes. A post-compact evaluation to determine the impact on maintenance is ongoing.</p> <p>Regarding irrigation tariffs, many farmers refused to pay tariff rates or chose not to utilize the irrigation infrastructure, which led to large scale degradation of the system.</p>
Tunisia Country Case (under preparation)	<p>Water demand management in Tunisia is critical, but fraught. Dry interior regions are extracting water at unsustainable rates, largely for agriculture. It is likely that drastic cuts in consumption will be mandatory in the coming decade. Irrigation farming is critical to the region's livelihood, yet irrigation is inefficient with high technical losses and few incentives to conserve (water tariffs are extremely low at only 1-5 cents per cubic meter). Grappling with this, the government is caught between needing costly investments in water efficiency but deep political reluctance to adjust water tariffs for fear of social unrest, riots and political backlash.</p>

Questions for EAC discussion

MCC seeks guidance on conditions for integrating full or partial cost recovery strategies in its investments while keeping both efficiency with equity concerns in view. Cost recovery can attract criticism, since the public often perceives certain services (e.g. water) as a human right. The 'social contract' may guarantee goods or services to low-income households, often via subsidies, regardless of costs or efficiency. Indeed, historically, high-income and middle-income countries have subsidized critical infrastructure for poorer and more remote populations. Meanwhile, poorly targeted subsidies, leakages to the non-poor, and difficulties implementing lifeline tariffs have added complexity to the basic challenge.³

1. Given MCC's 5-year Compact constraint, what are reasonable limitations to tariff policy timelines?
 - a. How is this likely to differ across sectors (e.g. power, water, transport)?
 - b. Should MCC push for greater cost recovery or leave this to the country's 'social contract'?
 - c. Should MCC aim for tariffs that achieve O&M or full cost recovery, including capital improvements?
2. What parameters can guide tariff policies as MCC navigates efficiency guidelines, ERR hurdle rate requirements, and social objectives?
 - a. How to balance cost recovery against the provision of:
 - i. Different types of "vital" services. Are roads as vital as electricity and water? And even within water, does access to irrigation, with implications for higher incomes, demand a different user fee calculus than, say, access to water treatment, with its implications for human health?
 - ii. What are the most efficient means to ensure access of essential goods to low income

- consumers (i.e. for essential services that are not affordable to the poor citizens at cost-recovery prices.)
- iii. How can governments address situations where subsidized rates are seen as a basic right, but the opportunity costs of subsidies (and political costs) are high?
 - b. When might public subsidies be justifiable as a means to satisfy non-economic preferences of the government?
3. Consumers may be willing to pay more for higher quality, including better service provision. (E.g. Power surges resulting from poor utility service can damage home appliances.) Should MCC link quality improvements to tariff adjustments?

Endnotes

1. Cost recovery to some degree has been a funded activity or a CP for nearly all MCC compact. However success has only been confirmed in the cases of Jordan wastewater treatment and Mongolia/El Salvador roads works.
2. Typically cross subsidization and government subsidization are done through lifeline tariffs or block tariffs to allow low prices for either the poor or the first small and fixed quantity for all consumers. However, MCC has found that it is rare that compact successfully implement well targeted lifeline and block tariffs.
3. MCC 2018 WSI Tariff Study found that 'historically lifeline block tariffs do a poor job of targeting subsidies to the poor as the poor have difficulty obtaining water connections and often consume less than the full subsidized block'. (Page 3)